Appendix.

"SECURITIES" AND "CONTINUITY OF INTEREST"

A Suggestion for the Reexamination of Two Concepts in the Reorganization Provisions of the Tax Laws.

Some years ago the question was asked in connection with the reorganization provisions of the Federal tax laws "whether verbal competition with life is a paying proposition." [1] Certainly the reorganization sections present the problem of fitting language to concrete cases in one of its most involved forms. The courts have wrestled manfully with these provisions, and to a considerable extent have achieved a construction which harmonizes them with their basic objective and purpose. But there is one situation in which a literalism, faithful not to the statute itself, but to an unnecessary construction of the statute, has been allowed to go far towards preventing the statute from being applied to cases which seem to be clearly within its intended scope.

This construction is illustrated by the recent decision in *Neville Coke & Chemical Co.* v. *Commissioner.*[2] That case involved a typical creditor's reorganization, the interest of the particular creditor in question being represented by three, four, and five-year notes. The debtor corporation was recapitalized, and the creditor received, in exchange for its notes, new debentures and common stock. Section 112(b)(3) of the Revenue Act of 1936 provided that: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged

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[1] Paul, *Reorganizations* in Studies in Federal Taxation, Third Series (1940) 3, n.4.

[2] C. C. A. 3d, March 22, 1945.

solely for stock or securities in such corporation. . . ."[3] But the court held that the gain on the exchange was taxable on the ground that the notes which the taxpayer gave up were not "securities" within the meaning of the statute.[4] In reaching this result, the court said:

> It is to be noted that the phrase "stock or securities" appears twice in §112(b)(3). Once it refers to what a party turns into a corporation being reorganized. The second appearance of the phrase relates to what a recipient takes from the reorganized company as a result of the transaction. We have no reason for thinking that the phrase has a different meaning in either of the two instances and the argument by the taxpayer that it does differ fails to convince us.

The court then concluded that notes received on an exchance were not "securities," citing *Pinellas Ice & Cold Storage Co.* v. *Commissioner*.[5] It added that neither notes nor any other form of debt interest represented a "proprietary interest in the enterprise," relying on *Le Tulle* v. *Scofield*.[6] On these apparently clear foundations, it rested its conclusion that the notes given up by the taxpayer in the *Neville* case did not fall within the statute. If the premises are sound, the conclusion no doubt follows. The purpose of this article is to suggest that the time has come to reexamine the premises. Are notes "securities" within the meaning of the statute? Did the Supreme Court really

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[3] INT. REV. CODE § 112(b)(3) is the same.

[4] It would follow equally that a loss on such an exchange would be recognized. This, however, will often be of little or no value to the taxpayer because of the limitations on the deductibility of capital losses. Indeed, the taxpayer will often desire to show that the loss on the exchange should not be recognized in order to put his eventual loss into another year when he can offset it against gains. *Cf.* note 45 *infra*.

[5] 287 U. S. 462 (1933).

[6] 308 U. S. 415 (1940).

decide that question definitely in the *Pinellas* case? What is the function and scope of the "continuity of interest" requirement? Did *Le Tulle* v. *Scofield* decide that that test can never be met by a debt interest on either side of the exchange?

The Pinellas Case.

Our investigation of these questions will naturally begin with the *Pinellas* case itself, which was decided by the Supreme Court in 1933. The Pinellas company was engaged in the ice business in Florida. It transferred its assets to the Citizen's Company and received in exchange $400,000 in cash, and $1,000,000 in three notes, payable monthly over a period of three and one-half months. The cash was used to discharge debts and obligations of the Pinellas company. The notes were held until they were paid off, when the proceeds were distributed to the Pinellas stockholders.

The question for decision was whether the Pinellas company was taxable on the gain realized on the transaction. This turned on the construction and application of three paragraphs in the Revenue Act of 1926. The first of these was the definition of a "reorganization" in Section 203(h)(1) of the Act as "a merger or consolidation (including the acquisition by one corporation of . . . substantially all the properties of another corporation)."[7]

The second provision was Section 203(b)(3), under which: "No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or

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[7] The definition of a reorganization is now included in INT. REV. CODE § 112(g). The provision as to mergers now applies only to "a statutory merger or consolidation", without any following parenthetical clause. The acquisition of all of the properties of a corporation is defined as a reorganization in § 112(g)(1)(C), but is limited to cases where the transfer is "in exchange solely for all or a part of its voting stock."

securities in another corporation a party to the reorganization.'"[8]

Finally, Section 203(e) came into operation. This is the so-called "boot" provision. It provided that where "the property received in exchange consists not only of stock or securities . . . but also of other property or money" the gain should be taxable, in the absence of distribution, but not in excess of the sum of the money "and the fair market value of such other property so received.'"[9]

The question before the Court in the *Pinellas* case could be approached in either one of two ways: (1) Was the transaction a "reorganization"? If it was not a reorganization, then the gain would be recognized because Section 203(b)(3) was applicable only to exchanges in connecton with a reorganization. Or, (2) Were the notes received "securities" within the meaning of Section 203(b)(3)? That paragraph applied only to an exchange of property "solely for stock or securities." Pinellas had received no stock. Therefore the transaction was not within the statute unless the notes could be regarded as securities. Under Section 203(e), the notes, if not "securities," would be "other property," and taxable to the extent of their fair market value.

It is obvious that what Pinellas had done was essentially to make a sale of its properties. The transaction was not one within the purpose or objective of the reorganization provisions, and it was not surprising that the Court should cast about for a means to construe the statute so as not to grant a tax benefit to such a sale when the gain on the sale for cash would have been taxed in full. The Court made this plain in its opinion, when it said:

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[8] Int. Rev. Code § 112(b)(4), now in force, is the same. This applies to the recognition of gain or loss on the part of the corporation, which was the question actually involved in the *Pinellas* case. The question of gain or loss to the stock or security holder is essentially the same, and is controlled by the parallel language in Int. Rev. Code § 112(b)(3). See note 3 *supra*.

[9] The corresponding provision now is Int. Rev. Code § 112(d).

> It would require clear language to lead us to conclude that Congress intended to grant exemption to one who sells property and for the purchase price accepts well-secured, short-term notes, (all payable within four months), when another who makes a like sale and receives cash certainly would be taxed.[10]

It is not surprising, therefore, that the Court held that the transaction was taxable. The significant point for present purposes is that it placed its result on both of the two grounds indicated above. Its basic decision was that "to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes."[11] But is also said that "These notes—mere evidence of obligation to pay the purchase price—were not securities within the intendment of the act and were properly regarded as the equivalent of cash."[12]

In retrospect, it now seems clear that the reference in the *Pinellas* case to the question whether the notes were "securities" or not was both unnecessary and unfortunate. The *Pinellas* case is justly famed as the first clear pronouncement by the Supreme Court of the "continuity of interest" test.[13] When the Court had decided that there was no reorganization, because there was no "merger or consolidation" in the absence of a real continuity of interest, it had decided all that needed to be decided. The decision that the notes were not "securities" was a natural enough one in a case of novel impression where the Court was obviously striving to formulate grounds to prevent the gain on a sale from escaping taxation. But, with the aid of hindsight, it may now be suggested that this reason

[10] 287 U. S. at 469.

[11] *Id.* at 470.

[12] *Id.* at 468-69.

[13] The doctrine was developed a few months earlier in the excellent opinion of A. N. Hand, C.J., in *Cortland Specialty Co.* v. *Comm'r*, 60 F. (2d) 937 (C. C. A. 2d, 1932), which was cited with approval by the Supreme Court in the *Pinellas* opinion.

was put too broadly. The real basis for the *Pinellas* decision was the complete break in the continuity of the taxpayer's interest in the property transferred. The brief passage in the opinion about securities now appears to have been fundamentally nothing more than another way of stating the continuity of interest test. Although the Court said that the notes were not "securities," one may with reason think that what the Court really had in mind was that the notes were not *such* securities as to meet the continuity of interest requirement which the Court appropriately found in the "merger or consolidation" phrase in the statute.[14]

The history of our law shows many places where a statement has been made which seems perfectly sound in the light of the case then before the court, but which turns out to have been too broad when further cases arise involving different facts. Dean Pound has put the point in an address in general terms, but in language which shows the appropriateness of a further examination into the real basis of the *Pinellas* decision:

> When the court has that same state of facts before it, unless there is some very controlling reason, it is expected to adhere to the former decision. But when it goes further and endeavors to formulate a principle, *stare decisis* does not mean that the first

[14] The passage in the Supreme Court's opinion in the *Pinellas* case with respect to "securities" was perhaps induced by the Government's brief, for which the present author had some responsibility, and which argued that the notes there involved were not "securities." Though the point was not clearly perceived, the essence of the argument was, however, that the notes were not such securities as to meet the continuity of interest requirement. *Cf.* the following passage from the brief: "It is implicit in the statute that the transaction shall result merely in a change of form and not in one of substance and that the corporation which has transferred its assets shall receive stock or securities which represent a continuing interest in the assets which have been transferred. Clearly, the notes in this case did not represent any interest of this character." Brief for the Government, p. 19, in *Pinellas Ice & Cold Storage Co.* v. *Comm'r,* 308 U. S. 415 (1940).

tentative gropings for the principle, what is said in the course of development of the principle by this process of judicial inclusion and exclusion are of binding authority. That explains a great deal. What is commonly spoken of as overruling of decisions, very often there is not an overruling of decision. When a principle has been worked out through this process of judicial inclusion and exclusion, as you look back over the course of development, you can see every case in that line would be decided exactly as it was by the principle finally formulated. But the reasoning may have been revised two, three, four times. What is overruled, therefore, is not a single decision in that line of cases, but the premature, the hasty generalization of a text writer or premature formulation on the part of a court in the beginning of this process.

A good deal of complaint grows out of too much inclination to generalize in a hurry, and too much inclination on the part of text writers to lay down something on the basis of a particular case as a universal proposition. It gets into the encyclopedias, gets reported in the reports, and before you know it, you have something that is a hasty feeling, or groping for a principle masquerading as an established principle in the law.[15]

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[15] Pound, *Survey of the Conference Problems* (1940) 14 U. OF CIN. L. REV. 324, 330-31. See also Pound, *What of Stare Decisis?* (1941) 10 FORDHAM L. REV. 1, 7-8: "The language of the earlier cases has been repudiated and no doubt ought to have been rejected in the light of further experience. But the results reached remain the same, are consistent throughout the course of decision, and in the end have yielded a workable principle. . . . It cannot be insisted upon too often that our common-law technique does not make the language authoritative, much less of binding authority. It is the result that passes into the law."

Cf. the reference of Taft, C.J., in *Tidal Oil Co.* v. *Flanagan,* 263 U. S. 444, 454 (1924), to "Certain unguarded language in *Gelpcke* v. *Dubuque,*" and other prior decisions.

Bonds as "Securities"

We may now consider the development of the "securities" virus which was implanted by the *Pinellas* opinion. After an interval of two years, *Helvering* v. *Watts*[16] came before the Court. In that case the stockholders of corporation *X* exchanged all of their stock for stock of corporation *Y* and bonds guaranteed by *Y*. The Court held that the bonds were "securities", and that no gain or loss was realized on the transaction. The continuity of interest requirement was met because the property received on the exchange included stock in *Y*.

The *Watts* case made it appear that the line was to be drawn somewhere between long term bonds and short term notes. The lower courts endeavored to draw this line,[17] though with indifferent success, for there was no clear standard nor apparent reason for drawing so sharp a line between these two types of interests. In *Le Tulle* v. *Scofield*, however, the Supreme Court held that an exchange of stock in *X* for cash and serial bonds in *Y* resulted in a taxable gain. The Court said: "We are of opinion that the term of the obligations is not material. Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise."[18] On the same day, in *Helvering* v. *Tyng*,[19] the Court held the gain was taxable when the property received on the exchange was twenty-year bonds.

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[16] 296 U. S. 387 (1935).

[17] See *e.g., Worcester Salt Co.* v. *Comm'r,* 75 F. (2d) 251 (C. C. A. 2d, 1935); *Comm'r* v. *Freund,* 98 F. (2d) 201 (C. C. A. 3d, 1938); *Comm'r* v. *Tyng,* 106 F. (2d) 55 (C. C. A. 2d, 1939), *rev'd per curiam, Helvering* v. *Tyng,* 308 U. S. 527 (1940); *L. & E. Stirn, Inc.* v. *Comm'r,* 107 F. (2d) 390 (C. C. A. 2d, 1939); Karl B. Segall, 38 B. T. A. 43 (1938), *rev'd,* 114 F. (2d) 706 (C. C. A. 6th, 1940).

[18] 308 U. S. 415, 420-21 (1940).

[19] 308 U. S. 527 (1940), *rev'g per curiam, Comm'r* v. *Tyng,* 106 F. (2d) 55 (C. C. A. 2d, 1939).

It is important to note that the opinion in *Le Tulle* v. *Scofield* does not refer at all to the question whether the bonds received were "securities" or not.[20] The decision is put solely in terms of continuity of interest. It would be difficult to say that long term bonds were not "securities" within the meaning of the statute. The Court was thus aided in focusing its attention upon the continuity of interest requirement. That this method was used to reach the result in *Le Tulle* v. *Scofield,* however, makes it seem less likely that the *Pinellas* case should be regarded as really a decision on the "securities" question.

In the light of the *Le Tulle* case, it now becomes clear that it makes no difference whether notes are "securities" or not when we are dealing with the property which is *received* on an exchange in connection with a reorganization. In either event, a debt interest, no matter what its term, is not sufficient to meet the continuity of interest requirement. On this, the *Pinellas* case is simply *a fortiori* from the *Le Tulle* decision. Indeed, the question is no longer of any particular importance, as the definition of a reorganization in the statute has now been changed so as to include only "a statutory merger or consolidation", or an exchange of property "solely for voting stock".[21] But the question what sort of interests are "securities" continues to be of great importance, for the phrase "stock or securities" still remains, not only in Section 112(b)(3) and 112(b)(4), but it is also to be found in Section 112(b)(5), in Section 112(b)(10), relating to bankruptcy exchanges, and in Sections 113(a)(6), 113(a)(7), 118, 332, and 333(b). It is unfortunate that the word "securities" should be given an unwarranted construction in its use in some or all of these sections, merely because the Supreme Court in the *Pinellas* case, groping for a means to avoid the application of the reorganization statute to a situation which was in all essence a sale, said that notes were not

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[20] See Silverson, *The Meaning of Le Tulle* v. *Scofield* (1940) 18 Taxes 492.

[21] Int. Rev. Code § 112(g).

"securities", when the real basis of the decision was that the notes did not involve the continuity of interest which now seems a clear and natural requirement of the statute, but which was then a concept in the process of unfolding.

Creditors' Reorganizations in Bankruptcy

The difficulty becomes apparent when we deal with a situation where the note or creditor's interest is on the transferor's side, that is, where the note is included in the property *given up* on the exchange, rather than in the property *received,* as in the *Pinellas* and *Le Tulle* cases. This is the problem of any creditor in connection with a reorganization, and in particular it is the problem in a so-called creditor's reorganization where the creditors of an enterprise, usually induced by force of circumstances, take over its formal ownership and operation. Although this is the type of situation where the reorganization provisions of the tax statute are most clearly justified and needed, the obstacles confronting such an adjustment have been numerous.

The question was first clearly presented in the *Kitselman* case.[22] That was a bondholders' reorganization, where the old bonds were exchanged for bonds and stock in a new corporation. The old stockholders got nothing. The old bondholders sought to deduct their loss, and it was the Government which successfully contended that the transaction was a reorganization. The court held that the bonds were "securities", and as this was prior to the decision of the *Le Tulle* case, it had little difficulty with the continuity of interest requirement.

Despite its victory in the *Kitselman* case, the Government refused to accept the claims of taxpayers that a creditor's reorganization was not taxable when a gain was involved. As it frankly but spinelessly put it, "in the past

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[22] *Comm'r* v. *Kitselman,* 89 F. (2d) 458 (C. C. A. 7th, 1937), *cert. denied,* 302 U. S. 709 (1937).

See Darrell, *Creditors' Reorganizations and the Federal Income Tax* (1944) 57 HARV. L. REV. 1009.

the Commissioner has taken the position in each case that was necessary to protect the revenues."[23] The Government's arguments in opposing the existence of a tax free reorganization in these cases are logically simple. They run like this: It has been established in the *Pinellas* case that notes are not securities, and in the *Le Tulle* case that bonds do not represent a proprietary interest in an enterprise. It is true that in both of these cases the notes or bonds were on the receiving side, that is, they were among the property received by the taxpayer on the exchange. But, (1) if notes are not securities when received, they cannot be securities when given up on the exchange. And, (2) if bonds do not represent a proprietary interest when received, they cannot represent a proprietary interest when given up. Therefore, there cannot be a tax free exchange of a creditor's interest in connection with a reorganization. If the creditor holds a note or book account, it is not a "security"; and no matter how a creditor's interest is denominated, the requisite continuity of interest cannot be present.

The second of these arguments has been partially demolished by the Supreme Court.[24] In *Helvering* v. *Alabama Asphaltic Limestone Co.*,[25] a corporation was adjudged a bankrupt. Its creditors bid in its property at the trustees' sale, and the property was transferred to a new corporation. The Government argued that there was no reorganization, because there was no continuity of interest. But the Court held that the creditors became proprietors when they "took steps to enforce their demands against their insolvent debtor".[26] Thus, the former creditors were treated like stockholders, and on this basis it was held that the

[23] Brief for the Petitioner, p. 10, in *Helvering* v. *Southwest Consolidated Corp.*, 315 U. S. 194 (1942).

[24] Congress has also diminished its application by providing for tax free exchanges in connection with all reorganizations in bankruptcy or receivership. See INT. REV. CODE §§ 112(b)(10), 112(l) added by § 121 of the Revenue Act of 1943.

[25] 315 U. S. 179 (1942).

[26] *Id.* at 183.

continuity of interest requirement was met. It is pertinent to observe that in the *Alabama Asphaltic Limestone Co.* case the interests of the creditors were represented by unsecured notes which had been taken for advances to the old company. The question in the case, however, was the basis of the assets to the new company. Thus, the Court did not have to decide whether the notes were "securities" or not within the meaning of Section 112(b)(3) of the statute.[27]

In the *Alabama Asphaltic Limestone Co.* case, the Court relied heavily on the actual commencement of bankruptcy proceedings.[28] This has caused some subsequent difficulties, particularly on the question whether the commencement of bankruptcy was itself a taxable event.[29] It is suggested, however, that all of these difficulties will disappear if the continuity of interest requirement in connection with bondholders' and creditors' reorganizations is subjected to a careful reexamination.

"Continuity of Interest"

The basic difficulty arises, it may be thought, because of the apparently logical proposition that since bonds (or other debt interest) cannot meet the continuity of interest requirement when received on the exchange, they cannot

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[27] It may be pointed out, however, in connection with the argument which follows, that it would be at least incongruous to hold that the transaction was tax free as far as the corporation was concerned, so that the old basis carried forward to the new company, and at the same time to hold that the transaction was not tax free as far as the creditors were concerned, so that a gain or loss would be recognized on their exchange, and a new basis attach to the securities which they received. Recognition that the notes are "securities" would eliminate this difficulty.

[28] See also *Helvering* v. *Cement Investors, Inc.*, 316 U. S. 527 (1942). This view was adopted in Bunker Hill & Sullivan Mining Co., 1 T. C. 1057, 1076 (1943), where the court said: "Until a court of equity intervenes stockholders and creditors of a corporation are not the owners of the corporate assets, notwithstanding the insolvency of the corporation."

[29] *Cf. Helvering* v. *Cement Investors, Inc.*, 316 U. S. 527, 534-35 (1942); *John Wanamaker Philadelphia* v. *Comm'r*, 139 F. (2d) 644, 648-49 (C. C. A. 3d, 1943).

meet that requirement when given up on the exchange. In order to meet this syllogism, the *Alabama Asphaltic Limestone Co.* opinion had to develop the elaborate, rather mechanical, and certainly troublesome notion of a transformation of the creditor's interest into a proprietary interest by the commencement of bankruptcy proceedings. May not the answer really be simpler than that? Is the basic syllogism sound? Is it really clear that because notes and bonds do not meet the continuity of interest test when they are received on an exchange, there can be no continuity of interest when notes and bonds are the property given up?

There would seem to be room to assert that this proposition is by no means clear. What is "continuity of interest"? The heart of the notion would seem to be in the basic word "continue". It is a progression, a going forward, not an equation. It does not make any difference what you start with. Whether there is a continuity of interest depends upon the "continuity", that is, upon what happens to what you start with, not on the interest which is the origin of the process. If you end up with notes or bonds in a solvent enterprise, the *Pinellas* and *Le Tulle* cases rightly hold that the continuity is broken. But if you end up with a stock interest, you have maintained the continuity, no matter what you start with. The creditor or the bondholder has an interest in the old enterprise. No one could deny that. It is true even when the old enterprise is solvent. It is certainly true when the old enterprise is insolvent, regardless of whether bankruptcy proceedings have actually been commenced or not. The basic question should be the continuity of that interest. Why should it make any difference whether the interest which is given up on the reorganization is a "proprietary" interest, or not a "proprietary" interest? That line is indistinct at best, and in any event, the creditor certainly has an interest, a stake, some sort of property, in the enterprise. Whatever it is, if he gives it up, and receives stock, his interest continues. That actual result in fact does not depend upon the nature of the interest

with which he started, nor upon the actual commencement of foreclosure or bankruptcy proceedings. The latter are possible, but not necessary, steps in the process. Whether there is continuity of interest or not *does* depend upon what the transferor *receives* on the exchange; but it does not depend upon what he starts with, upon what he *gives up* on the exchange. It is a one-way reaction. The fact that the receipt of bonds or notes will break the continuity no matter what you start with, does not mean that there cannot be complete continuity of interest if you start with notes or bonds and end up with something else.

It is argued, therefore, that the continuity of interest requirement should be concerned solely with what is *received* on the exchange, and not at all with what is given up. On this basis, it would follow that all creditors' reorganizations meet the continuity of interest test when the creditors end up as stockholders, regardless of whether the creditors were note holders or bondholders, or creditors on open account, and regardless of whether bankruptcy or receivership proceedings have actually been commenced. As a merely factual matter, why should there be any question about this? On the whole, the creditors of an embarrassed enterprise ordinarily deserve somewhat more consideration than the stockholders. They not only have a stake in the enterprise, but one which ranks ahead of the stockholders. They ordinarily have acquired their interest with the expectation that they will be paid in cash or its equivalent. But there are risks in any enterprise, and creditors often find that their investment is thoroughly frozen. They would gladly take cash if they could, and get out. But there is no cash for them. Their claim for cash has become merged in the enterprise. They have to work their way out of the situation the best they can. And if they project their interest into a new corporation in exchange for that corporation's stock, they would seem to be precisely the sort of persons for whom the reorganization provisions were basically designed. They are not realizing on their interests. They are merely regularizing a

situation which has been thrust upon them, formally recognizing that their position as creditors has evaporated and that they have in essence become the owners of the enterprise. But when they take stock in the new corporation the continuity of their interest is unabated. Indeed, the fact of the *continuity* is accentuated by the very change from debt to stock.

Recapitalizations

This conclusion has in effect been reached in the cases involving recapitalizations, as distinguished from transfers to a new corporation, where the property given up on the exchange is bonds. In these cases the continuity of interest requirement has been minimized. That is natural, as the test had its origin in a construction of the words "merger and consolidation" in the definition of a reorganization, and these words have no applicability to a reorganization which is carried out through a recapitalization. On this basis it has been held that there was a tax free reorganization when old preferred stock was exchanged for new bonds,[30] and when old common stock was exchanged for new common stock and bonds.[31] Probably the most striking case is *Commissioner* v. *Neustadt's Trust*,[32] where there was an

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[30] See, *e.g.*, Lelia S. Kirby, 35 B. T. A. 578 (1937), *modified on other grounds*, 102 F. (2d) 115 (C. C. A. 5th, 1939); Clarence J. Schoo, 47 B. T. A. 459 (1942), *dismissed and aff'd without opinion*, C. C. A. 1st, March 29, 1943; Redford Lumber Co., 42 Prentice-Hall BTA Mem. Serv. ¶ 42,564 (Oct. 21, 1942); Annis Furs, Inc., 2 T. C. 1096 (1943); Arthur J. Hooks, 44 Prentice-Hall TC Mem. Serv. ¶ 44,284 (Aug. 22, 1944).

[31] See, *e.g.*, Edgar M. Docherty, 47 B. T. A. 462 (1942), *remanded to Tax Court*, C. C. A. 1st, January 12, 1943; Adam A. Adams, 4 T. C. No. 140 (April 26, 1945). In the latter case, an order was issued, on May 1, 1945, that the decision be reviewed by the full Tax Court. This may or may not indicate the possibility of some change in the current of the Tax Court's decisions.

[32] 131 F. (2d) 528 (C. C. A. 2d, 1942), *aff'g*, 43 B. T. A. 848 (1941). See also Edith M. Greenwood, 41 B. T. A. 664 (1940); Koppers United Co., 43 Prentice-Hall TC Mem. Serv. ¶ 43,231 (May 5, 1943), *aff'd on other issues*, 141 F. (2d) 1023 (C. C. A. 3d, 1944); Jeanne G. Miller, 44 Prentice-Hall TC Mem. Serv. ¶ 44,077 (Mar. 14, 1944); Mary N. Crofoot, 45 Prentice-Hall TC Mem. Serv. ¶ 45,036 (Jan. 25, 1945).

exchange of twenty-year debentures for new ten-year convertible debentures in the same company. The court held that this was a tax free recapitalization, although it did not affect the capital stock of the company. This would seem to be a sound result. If there is any continuity of interest requirement in recapitalization cases, there would seem to be a real continuity when a bondholder remains a bondholder. When a shareholder becomes a creditor, as in many of these cases, the continuity is not so clear. A rigid application of the *Le Tulle* case would strike these transactions down. But the *Le Tulle* case should not be applied, and has not been applied in these recapitalizations. Congress has not enacted a continuity of interest requirement in terms, and there is no basis for reading it into the word "recapitalization" as there was in the case of the phrase "merger or consolidation".[33]

Nevertheless, there is difficulty, even in the recapitalization cases, when a note is introduced into the picture. Thus, in *Wesley V. E. Terhune*,[34] the holder of preferred stock exchanged it on a recapitalization for cash and a note. Of course the cash was taxable, but the Board held that the note was taxable too. This was not because of any application of the continuity of interest test as such, but because the Board concluded that the note received was not a "security," in accordance with the *Pinellas* case. Thus the Board felt that there was not an exchange of "stock or securities," as required by Section 112(b)(3), even if the transaction was a recapitalization and thus a reorganization. As long as the current doctrine that notes are not "securities" prevails, it would seem to be impossible to have a tax free recapitalization of any corporation, no matter how much such a recapitalization may be needed as a matter of business procedure and convenience, where

[33] *Le Tulle* v. *Scofield* was distinguished on this ground in Clarence J. Schoo, 47 B. T. A. 459 (1942), *dismissed and aff'd without opinion*, C. C. A. 1st, March 29, 1943; and in Mary N. Crofoot, 45 Prentice-Hall TC Mem. Serv. ¶ 45,036 (Jan. 25, 1945).

[34] 40 B. T. A. 750 (1939).

a part of the claims against the corporation is represented by notes, or open accounts, as distinguished from stock or bonds. That is really a curious and incongruous stuation.

"Securities"

In many situations it is not enough to know that the transaction qualifies as a reorganization. There will necessarily be some sort of exchange on the transaction, and gain or loss will be recognized unless the exchange involves "stock or securities." Under Section 112(b)(3), involving the security holder, gain or loss will be recognized unless he both gives up and receives "stock or securities" on the exchange. In the case of a corporation which is a party to a reorganization, and which transfers its property under the plan of reorganization, gain or loss will be recognized under Section 112(b)(4) and Section 112(b)(10) unless it receives "stock or securities" on the exchange.

To date, little or any difficulty has developed in connection with the meaning of the word "stock." The word "securities" has, however, received a restricted meaning, the sole basis for which is apparently the decision in the *Pinellas* case. Since the phrase is "stock or securities," it seems fairly clear that "securities" must include something besides "stock." This was recognized in the *Watts* case[35] where bonds received on an exchange together with stock were held to be "securities," so that no gain was recognized. Because the transaction involved the receipt of stock as well as of bonds, the continuity of interest requirement was regarded as satisfied, although it is by no means clear how much stock or what proportion of stock must be received to meet that test. When the *Le Tulle* case came before the Court, the *Watts* case made it impossible to hold that bonds were not securities, and thus the decision that the *Le Tulle* transaction was not a reorganization was put solely on the continuity of interest ground.

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[35] *Helvering* v. *Watts,* 296 U. S. 387 (1935). Cited note 16 *supra.*

The net result of these cases is that it has been established that bonds are "securities," while the *Pinellas* case is regarded as holding that notes are not "securities." No one knows just where the line between bonds and notes is to be drawn. Apparently the matter turns a good deal on the terminology which the parties apply to the particular instrument.[36] Remembering that we are not now talking about the continuity of interest requirement, but solely about the question of the meaning of "securities," no reason is perceived why the term of the instrument, or its interest rate, or its status as a lien on the property, or its name, or the elaborateness of its engraving, should have any bearing on the question whether it is a "security."

It is suggested that any debt obligation of any sort in a corporation a party to a reorganization should be treated as a "security" for the purposes of these sections of the tax statute.[37] After all, a note is not money. It is at best an investment, a promise for the payment of money, a claim against an enterprise. If it be said that many notes are readily marketable, and that money can be quickly realized upon them, there are at least two ready answers. (1) The same is often true of stock received on a reorganization exchange, but it is clear that the mere *receipt* of stock, no matter how marketable or how readily convertible into cash, does not make a transaction taxable. (2) If the obligation received is in fact turned into cash, by being sold or otherwise, then there will, of course, be a recognizable gain or loss on that event. But that is no reason for saying

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[36] Of course, if it is desired to make the transaction tax free, the parties call the instrument received a bond, and make it look like a bond. In Mary N. Crofoot, 45 Prentice-Hall TC Mem. Serv. ¶ 45,036 (Jan. 25, 1945), the property received was twenty-year registered 5% bonds. These were held to be "securities" even though the obligor could call them for payment within two years after issue.

[37] See McLaren, *Do "Securities" Include Notes under Section 203?* (1928) 6 NAT. INCOME TAX MAG. 135. *Cf.* I. T. 2392, VI-2 CUM. BULL. 17 (1927), where warrants to buy notes in a corporation were held to be "securities" when received on an exchange; G. C. M. 2000, VI-2 CUM. BULL. 248 (1927), where mortgage notes were held to be securities under the Federal Farm Loan Act.

that a gain or loss must be recognized on the receipt of the obligation, while it is still held, while the holder still retains his stake in the enterprise.

It is true that the *Pinellas* opinion gave as one of the grounds for the decision that the notes involved there were not "securities." It has already been argued that, with the benefit of some twelve years of hindsight on the problem, we may now properly conclude that the reason which the Court was striving to formulate was not that the notes were not "securities," but that they were not such "securities" as to fulfill the continuity of interest requirement. The question was not extensively considered in the *Pinellas* case. The only reference to "securities" is in a single sentence in the opinion. It would seem that the time is now ripe for a re-appraisal of the whole problem.

In the cases which have arisen on this point, this aspect of the *Pinellas* decision has been quite automatically applied. Indeed, the cases in this field seem to be rather remarkable for their mechanical approach to the problem without any careful consideration of the structure and the objective of the statute. Nor has this aspect of the *Pinellas* case received careful consideration by any of the several authors who have written in this field.[38] When notes

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[38] *Cf.* 3 MERTENS, LAW OF FEDERAL INCOME TAXATION (1942) § 20.60; PAUL, *Reorganizations,* in STUDIES IN FEDERAL TAXATION, THIRD SERIES (1940) 3, 101; Darrell, *Creditors' Reorganizations and the Federal Income Tax* (1944) 57 HARV. L. REV. 1009; Fahey, *Income Tax Definition of "Reorganization"* (1939) 39 COL. L. REV. 933; Silverson, *The Meaning of Le Tulle v. Scofield* (1940) 18 TAXES 492.

The point here made was, however, clearly forecast in a Note, *Continuity of Interest in Reorganization under the Federal Income Tax* (1940) 49 YALE L. J. 1079, 1083-84: "The affinity between the concept of continuity as applied to 'securities' and as applied to the definition of reorganization was recognized by holdings to the effect that bonds satisfied the continuity requirement *because* they were 'securities.'

"The holdings in these last cases were persuasive. If bonds satisfied the continuity requirement for purposes of the exchange and boot provisions, as in the *Watts* case, it seems logical that they would also satisfy it for purposes of the definition. . . . In the light of the

are *received* on the exchange it ordinarily makes little difference whether they are regarded as "securities" or not, as the transaction will not meet the continuity of interest test. But from the premise that notes received are not "securities," based on the *Pinellas* case, it has been determined with rigid logic that notes are not securities when they are given up on the exchange, with the unwarranted and undesirable result that there is apparently no possible way that a noteholder or book creditor of a corporation can enter into an exchange which will be tax free, no matter what sort of interest he receives on the exchange. This structure may well be sound if the premise on which it stands—that notes are not "securities"—is sound. But it would wholly collapse if it should now be perceived that the *Pinellas* case did not need to decide that notes were not securities, and should not now be regarded as having decided anything except the relationship of notes received to the continuity of interest requirement.

In one of the earliest cases in which a note was involved on the transferor's side, that is, where a note was given up on the exchange, the distinction was clearly seen. In *Burnham* v. *Commissioner,*[39] stockholders in a corporation also held its note. They exchanged the note for new stock and endeavored to deduct a loss. The court held that no loss was deductible because this was an exchange of securities in connection with a recapitalization. Of course, this was before the *Le Tulle* case was decided, but the *Le Tulle* case has no bearing on the "securities" question. In reaching its result, the court distinguished the *Pinellas* and

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affinity of the two rules, however, there is a danger that the lower courts will impose on the term 'securities' the same requirement of a proprietary interest which the *Le Tulle* case had applied to the definition of a reorganization."

[39] 86 F. (2d) 776 (C. C. A. 7th, 1936), *cert. denied,* 300 U. S. 683 (1937). See also *Martin* v. *Chandis Securities Co.,* 128 F. (2d) 731 (C. C. A. 9th, 1942); *Comm'r* v. *Huntzinger,* 137 F. (2d) 128 (C. C. A. 10th, 1943). *Cf. Hoagland Corp.* v. *Helvering,* 121 F. (2d) 962, 964 (C. C. A. 2d, 1941).

Cortland[40] decisions. It said: "It is obvious that both courts based their decisions not so much on the ground that the short-term purchase money notes were not securities as that the transactions involved were not reorganizations."[41] And it added: "Here, we unquestionably have an interest of the petitioner in the corporation prior to its recapitalization as evidenced by its long-term notes; upon the recapitalization we see that interest exchanged for shares of stock. But the same party holds the interest, although it is carried over to the recapitalized corporation in changed form."[42] This case has been distinguished[43] on the ground of the length of the term of the notes. But why should that make any difference? We are dealing with the transferor's side of the exchange, that is, with the property *given up* in connection with the reorganization. A demand note may be just as sick as a long-term, beautifully engraved gold bond. A demand note may in fact represent a very long and deep "continuity" of interest in the enterprise. In such a case, both notes and bonds, as well as stock, are equally in need, and equally deserving, of the facilities of the reorganization provisions of the statute.

After the *Burnham* decision, the courts have consistently gone the other way. In *Commissioner* v. *Sisto Financial Corp.*,[44] the taxpayer owned notes in the *X* Corporation. *X* transferred all of its assets to *Y* in exchange for *Y*'s stock, and the stock was delivered to the taxpayer in exchange for his notes in *X*. In a later year, the taxpayer sold his *Y* stock, and the question was his basis for computing gain on that sale. He contended that his basis for the notes carried over, and became the basis for the *Y* stock. But the Commissioner contended that the exchange was not tax free, and that the basis of the *Y* stock was

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[40] *Cortland Specialty Co.* v. *Comm'r*, 60 F. (2d) 937 (C. C. A. 2d, 1932).

[41] 86 F. (2d) at 777.

[42] *Id.* at 777-78.

[43] Pacific Public Service Co., 4 T. C. No. 87 (Feb. 8th, 1945).

[44] 139 F. (2d) 253 (C. C. A. 2d, 1943), *rev'g*, 47 B. T. A. 425 (1942).

its much lower market value at the time it was received.[45] The Commissioner prevailed. The court cited the *Pinellas* case and concluded: "A fortiori, the demand notes were not securities."[46] It gave no heed to the fact that the notes involved in the *Pinellas* case were received on the exchange, while in the case before the court the notes were on the transferor's side. It did not reexamine the *Pinellas* case to determine whether the opinion there should really be regarded as determining that a note is never a security for the purpose of these statutory provisions.

The most recent expression of this point of view is found in *Neville Coke and Chemical Co.* v. *Commissioner*,[47] with which this discussion commenced. This case, too, involved a creditor which only sought to take the steps necessary to put its enterprise in order. Again the *Pinellas* case and its progeny were rigidly applied, though the note here was on the transferor's side of the exchange. Again, there was no consideration of the basic question whether this sort of an exchange is not precisely within the essential purpose of the reorganization provisions, and whether that purpose cannot be achieved by a re-appraisal of the "securities" portion of the *Pinellas* decision.

Following the lead of the appellate courts, the Tax Court has reached the same result.[48] In all of these cases,

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[45] This illustrates the point that the Commissioner wins both ways in many of these cases. If there is an apparent gain on the exchange, he contends that the gain must be recognized and taxed. If there is a loss, the Commissioner presently contends that § 112(b)(3) is not applicable. Although the loss is "recognized," ordinarily a very small portion of it is deductible, because of the severe restrictions on the deductibility of capital losses. But since the loss was "recognized," the property received on the exchange takes the low basis determined by its fair market value, and the Commissioner claims an increased (and wholly artificial) gain on the subsequent sale of the stock.

[46] 139 F. (2d) at 256.

[47] C. C. A. 3d, March 22, 1945.

[48] Bunker Hill & Sullivan Mining Co., 1 T. C. 1057 (1943) (here the taxpayer sought and obtained a deduction for a loss on the exchange); F. T. Bedford, 2 T. C. 1189 (1943), supplemental opinion, 44 Prentice-Hall TC Mem. Serv. ¶ 44,123 (Apr. 17, 1944); Globe-News Publishing Co., 3 T. C. 1199 (1944); Pacific Public Service Co., 4 T. C. No. 87 (Feb. 8th, 1945).

the result has been reached on what may be regarded as largely mechanical grounds. The *Pinellas* case is cited, and usually the *Sisto* decision of the Second Circuit Court of Appeals. With it thus established that notes are not securities, the result follows automatically.

The nature of the results reached in these cases is shown by the decision in *F. T. Bedford*.[49] In that case, the taxpayer owned preferred stock in corporation *X*, which was guaranteed by corporation *Y*. Both *X* and *Y* were reorganized under Section 77B of the Bankruptcy Act, and the taxpayer received new preferred stock in each of the reorganized companies. The Tax Court held that the receipt of the *Y* stock was taxable, for the reason that the taxpayer had only a creditor's claim against *Y*, and that was not a "security" within the meaning of the statute.[50]

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[49] 2. T. C. 1189 (1943), supplemental opinion, 44 Prentice-Hall TC Mem. Serv. ¶ 44,123 (Apr. 17, 1944).

[50] The tenuousness of the distinction is shown by the decision in *Skenandoa Rayon Corp.* v. *Comm'r*, 122 F. (2d) 268, 270 (C. C. A. 2d, 1941), that "The stockholders' rights to dividend arrears, if treated as separate from the stock itself, must certainly be considered as 'securities in a corporation a party to a reorganization'— a curious 'security' to be sure, but nevertheless a 'security.'" To the same effect is Globe-News Publishing Co., 3 T. C. 1199 (1944). *But cf.* M. W. Ellis, 3 T. C. 106 (1944), where "conditional rights certificates," representing possible future dividends, were held to be "no part of the capital structure of the company."

Preferred stock, with no voting rights in any event, and redeemable at any time on thirty days' notice, and sooner if the notice was waived, has been held to be "securities." Schweitzer & Conrad, Inc., 41 B. T. A. 533, 541 (1940). The decision seems eminently sound, but it emphasizes the futility of the view that notes are not "securities." The line is hard enough to draw when there is really a reason for drawing it. *Cf.* Note, *Deductions for Interest under the Federal Income Tax* (1942) 55 Harv. L. Rev. 1189.

The phrase "stock or securities" also appears in Int. Rev. Code § 371, relating to exchanges in obedience to orders of the Securities and Exchange Commission. But here someone has seen the problem, and § 373(f) provides that for the purposes of Supplement R the term "stock or securities" means shares or certificates of stock, "notes, bonds, debentures, and evidences of indebtedness. . . ." The Committee Report states that this change was made "In order to facilitate exchanges or distributions in furtherance of the policies

If we cannot look behind the *Pinellas* case, this result follows readily enough. But if we can recognize that no such question was necessarily decided in the *Pinellas* case, and that situations of this sort fall fully within the objectives of the reorganization provisions of the statute, then we can recognize that we have long been blinded by a too narrow construction of the word "security," and we can extend the application of the statute to the very sort of situation to which it most clearly should apply. Is there any reason why a creditor of an embarrassed corporation, no matter how unsecured his claim may be, and no matter what its term, should not be able to participate in working his claim out by exchanging it for stock? Is there any reason why it should make any difference at all in such a situation what the term of his claim is? Should he be able to get a deduction for a loss (if he can use it) merely by converting the form of his claim from debt to stock? [51] When a corporation is wholly solvent, a person having a demand note can get his money promptly. But when the

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of section 11(b) of the Public Utility Holding Company Act of 1935." Sen. Rep. No. 1567, 75th Cong., 3rd Sess. (1938) 36. There would seem to be no real reason why the rule that notes are securities should be confined to the notes of public utility holding companies. In a very real sense, 373(f) can be advanced as an authority for the view suggested by this article.

[51] *Cf.* H. R. Rep. No. 704, 73rd Cong., 2d Sess. (1934) 14, which concludes that "the reorganization provisions should be retained" because they "will prevent large losses from being established" where investors "receive securities in a newly reorganized enterprise which are substantially the same as their original investments." Sen. Rep. No. 558, 73rd Cong., 2d Sess. (1934) 16-17, is similar.

The reorganization provisions were originally adopted "in order that ordinary business transactions will not be prevented"; they were intended to apply where there was "a mere change in the form of ownership of the property," and were "based on the theory that the types of exchanges specified . . . are merely changes in form and not in substance and consequently should not be considered as effecting a realization of income at the time of the exchange." Statement of the Changes Made in the Revenue Act of 1921 by H. R. 6715 (1924) 6, 10, commonly, though not quite accurately, cited as the Gregg Statement. To the same effect is H. R. Rep. No. 179, 68th Cong., 1st Sess. (1924) 13, 16; Sen. Rep. No. 398, 68th Cong., 1st Sess. (1924) 14-15, 17.

corporation is embarrassed, the holder of a demand note or a book account may be just as inextricably tied up with the situation as if he had a twenty-year non-redeemable bond.

These are intricate problems. They must be considered patiently, and step by step. But the situations in which the statute has been denied application are highly real ones. The argument of this article is that the statute has been denied effect in a situation to which it clearly should apply because of a combination of (1) an original confusion in the *Pinellas* case between the continuity of interest test and the definition of the word "security," and (2) a literal and uncritical application of the construction of that word resulting from the confusion. If there is any merit in these contentions, it is not yet too late to recognize that the lowly creditors of a corporation have an interest fully within the purpose of the reorganization provisions of the statute. Bondholders have such an interest. Stockholders have such an interest. Is there any reason at all why noteholders and other creditors, lying in between, should not have exactly the same status?

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